

**Eighteenth Tax Conference
5-8 October 2010, Tokyo
Executive Summary of Tax Conference Proceedings**

I. INTRODUCTION

1 Tax office and ministry of finance officials from 11 Pacific Island Asian Development Bank (ADB) Developing Member Countries (DMCs) participated in the Eighteenth Tax Conference to discuss the potential role of bilateral tax treaties and tax treaty models in the Pacific region. The Conference, sponsored and organized by the ADB, ADB Institute (ADBI), the Tax Bureau of the Ministry of Finance, Japan and the Organisation for Economic Cooperation and Development (OECD), was financed through the Japan Fund for Poverty Reduction (JFPR), a unique grant facility funded by the Government of Japan to the ADB. The co-coordinator of the Conference was Mr. Teruo Ujiie, Senior Capacity Development Specialist, Public Management, Governance, and Participation Division (RSGP), Regional and Sustainable Development Department (RSDD) of the Asian Development Bank.

2 The focus on the Conference was on the role of bilateral tax treaties in fostering cross-border economic relations by addressing the problems of double taxation and opportunities for tax avoidance that may accompany international trade and investment.

II. OPENING REMARKS

3 Delegates were welcomed to the conference by **Mr. Teruo Ujiie**, Senior Capacity Development Specialist, RSGP, RSDD, ADB. Two brief introductory sets of remarks followed.

4 The first introductory presentation was made by **Mr. Tadashi Yokoyama**, Director, International Tax Policy Division, Tax Bureau, Ministry of Finance of Japan. Mr. Yokoyama welcomed delegates to the Eighteenth Tax Conference.

5 Mr. Yokoyama noted that tax forum evolved from a series of tax conferences that ADB and ADBI had organized commencing in 1991. Those conferences had made valuable contributions to regional tax policy making and establishing international cooperation and communication ties. The accelerating globalization of the world's economies has highlighted the importance of that cooperation and those ties, as well as the need for expansion of the tax treaty network. By allocating taxing rights and assisting nations to combat tax evasion, tax treaties play an important role in allowing countries to fully harness the benefits of globalization. They also play an indispensable role in promoting fair and efficient fields for all nations and economic players.

6 Tax authorities face increasing responsibilities to ensure sustainable development of the international economy. In this regard, it is crucial that tax authorities strengthen multilateral cooperation and share expertise. The ADB Tax Conference Program provides an opportunity for regional administrators to focus on these issues and exchange views.

7 Mr. Yokoyama concluded by thanking the ADBI Secretariat staff who prepared the Conference and the resource persons participating in the event.

8 The second introductory presentation was made by **Mr. Kuniki Nakamori**, Resident Director General, Japan Representative Office of the ADB, Tokyo. Mr. Nakamori noted that the annual Tax Conferences organized by the ADB and ADBI over the past two decades have

provided a platform for tax policy makers and administrators in the Asia-Pacific region to discuss emerging issues and cooperation on tax policies and administration.

9 With growing globalization and regionalism and the advance of information technology, cross-border tax issues are becoming more and more important as evidenced by the rapidly increasing number of international tax treaties, in particular, in developing and transitional economies in the region.

10 For instance, in ASEAN, a clear target has been set to complete the network of bilateral agreements on avoidance of double taxation among all Member States by 2010. This target signifies an important step towards harmonizing tax regimes across ASEAN countries. It also recognizes the important roles of international tax policies in promoting intra-regional trade and investment.

11 From international investors' perspective, a clear understanding of tax obligations particularly on cross-border income flows is crucial to their selection of countries in which they invest. Through bilateral tax treaties, tax obligations of these income flows can be clearly specified in a transparent manner. It is expected that more tax treaties will be concluded in coming years. The focus of the 18th Tax Conference on international tax treaties and related key issues on a sub-regional basis is thus timely and relevant as a means of enhancing the understanding of and the capacity participants to negotiate tax treaties that are fair, transparent and mutually beneficial. The focus is on tax treaties as a tool to (i) regulate taxing rights between the parties concerned, (ii) provide a mechanism for resolving disputes on profit shifting, and (iii) establish procedures for the exchange of information required to properly tax multinational corporations.

12 To this end, the conference provided an overview of the two leading Model Tax Treaties currently used as the basis for bilateral treaties, namely OECD and United Nations Models, and presentations from two countries on the approach they take to treaty negotiations.

13 Finally, Mr. Nakamori noted the support of the JFPR that made the conference possible, as well as the contributions by the OECD, the United Nations, the IMF, the Pacific Financial Technical Assistance Centre, and the International Bureau of Fiscal Documentation.

III. KEYNOTE SPEECH: MARGARET COTTON

14 The opening presentation of the 18th conference was a keynote speech by **Ms. Margaret Cotton**, Revenue Advisor to the Pacific Financial Technical Assistance Centre in Suva, Fiji. The paper provided a comprehensive survey of the current revenue systems in the Pacific region.

15 The global economic crisis highlighted the significant fiscal challenges that face Pacific Island Countries (PICs) in the coming years. The crisis placed pressure on government budgets in most PICs. With fiscal deficits rising, effective revenue collection becomes increasingly important to moderate macroeconomic pressures and maintain crucial public expenditure programs.

16 Even with a global economic recovery, fiscal challenges are likely to intensify in PICs, particularly as they look to increase expenditure levels in areas key to growth and poverty reduction. This will have to be achieved in most countries at the same time as adjusting to one

or more additional challenges which include: reducing customs tariffs in the context of trade liberalization, reducing high public debt, adjusting to declining overseas assistance and containing drawdowns from trust funds to sustainable levels.

17 Addressing the challenges requires reforms to both revenue and expenditure policy, whether pressures come from decreasing revenue or through increased expenditure needs the objective remains the same. Countries need to be able to achieve and sustain an overall budget balance consistent with macroeconomic stability. Given the size of the pressures, responses are likely to have to come from both revenue raising and expenditure restraint. The balance between the two will depend on each country's political and economic circumstances. A broad, stable revenue base will moderate the impact of shocks and enable well-designed expenditure programs to be implemented.

18 Revenue reforms should create a system that is fair, transparent and easy to administer and consistent with the resource needs of the government. Taxation of domestic consumption and income generation should be the fundamental element of the revenue system, as it is sustainable and buoyant. Countries should aim to (i) levy taxes on the broadest possible base and minimize exemptions and relief to enable the lowest possible rates and (ii) effectively administer taxes through adequate systems, processes and capabilities to achieve high levels of voluntary compliance and minimal opportunities for corruption.

19 Experience in the Pacific and elsewhere suggests a clear strategy. Income taxes, and consumption taxes, ideally through a value added tax (VAT), supported by excise taxes, provide a broad, stable base for taxation. Industry specific taxes can also be valuable additions to the tax base. The place for international treaties requires much further deliberation.

20 Income tax has the potential to become a more effective revenue earner for PICs. Income taxes will continue to play an important role in revenue collection in PICs but need to be harmonized with the introduction of a VAT. Income taxes should be levied on net profit and not gross revenue to ensure efficiency and fairness.

21 A VAT is the best method of taxing domestic consumption. Although VATs are conceptually complex, simple versions can be implemented successfully in even the smallest economies.

22 Excise taxes can be a useful supplement and are a major potential source of revenue for PICs. Both excise rates and the extent of excise taxes applied are relatively low in the Pacific. Extending their reach could be a useful method for replacing lost customs duties. Excises should, however, be used judiciously as there should be a sound economic or social policy reason for applying an excise over and above a consumption tax.

23 Tourism taxes, if well designed can provide valuable additional revenue at relatively low cost. However, decisions to introduce small, sector specific taxes have to be carefully balanced against the pressures they add on the tax administration and the distortions they can create.

24 Natural resources can provide a valuable addition to domestic taxation. For those PICs with large fishing grounds, efforts should be made to negotiate collective agreements with fishing nations to ensure that fishing is a sustainable activity and to provide greater income to the resource-owning PICs. Other PICs, in particular Papua New Guinea, Solomon Islands and perhaps Palau, have significant mineral resources that are being developed. Taxation of these mineral resources will support the revenue base. At the same time, these countries should

strengthen or establish stabilization funds to ensure that these revenues—which will be volatile—are managed effectively and that income flowing from mineral resources is integrated in a transparent and well-managed way with the budget.

25 Improvements in tax design and compliance are also necessary to improve revenue collection. Income tax rates across the Pacific are likely to continue their gentle downward trajectory as PICs look to promote private sector growth and investment. Reversing the erosion of the income tax base from tax holidays, exemptions and concessions is therefore required to yield additional revenue while reducing distortions and inequities. This can be achieved while maintaining some incentives by shifting to investment allowance schemes that would apply to all new investors and to allow tax holidays and current exemptions to expire. Coordination of investment incentive schemes and of tax rates across the Pacific island countries could help ensure that PICs do not undermine each other's growth and revenue prospects through tax competition. Modernizing the design of taxing legislation and incorporating double taxation concepts into the tax design can also help.

26 Parallel strengthening of the revenue administration is vital for successful policy reform. Given the resource constraints (staff numbers, skills and basic infrastructure) faced by PIC administrations, voluntary compliance is the key to success as it yields higher collections for each dollar spent on administration.

27 The role of international tax treaties in improving revenue collection for PICs needs further deliberation. A double tax agreement (DTA) effectively means that one country gives up rights to tax certain types of income, usually source income, in return for rights to tax other types of income – generally residence income. Where there is an equal share of trade and investment between the contracting countries the tax given up on source income would be expected to be offset by the tax gained on residence income. However this is not necessarily the case for developing countries where trade and investment flows are unequal. If the developing country gives up rights to tax income sourced from that country in favor of rights to tax income of its residents in the developed country they may well receive less from their expatriate residents than they would from taxation of business operating in the developed country.

28 PICs have favored tax holidays and incentives as a means to encourage investment rather than DTAs. As a result it is not uncommon for multinational companies to pay relatively little income tax in the developing country and yet pay tax in their home country. This results in the developed country (typically Australia and New Zealand) benefiting from tax on the profits and the developing country bearing the lost revenue.

29 There is merit in developing PICs negotiating treaties with their main trading partners because of the investment coming from those countries and the number of expatriate islanders living in those countries. There might also be political reasons for negotiating international treaties between PICs but the time and expense of the negotiations must be weighed against the economic benefits.

30 PICs may benefit from greater enforcement powers against their offshore nationals where treaties allow for administrative co-operation. However, the practical reality of this is limited given the current administrative capacity of PIC revenue administrations and the likely unequal volume of reciprocal requests.

31 The single most pressing reason for PICs to negotiate international treaties has been acceptance into the international community rather than revenue collection. The global financial crisis focus on financial transparency and tax evasion has seen a proliferation of signed agreements for the exchange of tax information, many with countries PICs would rarely otherwise transact with.

32 PICs face a wide range of options to improve revenue collections including broadening the tax base, redesigning taxes and administrative efficiencies. Getting the balance right, to achieve the optimum combination of domestic and cross border taxation, and modernized design whilst recognizing the administration resource and capacity constraints, is the common challenge.

IV. THE OECD MODEL TREATY: DAVID PARTINGTON

33 While there a number of national “models” used by particular countries in the course of their treaty negotiations, all are based on the OECD model (known formally as the “OECD Model Tax Convention on Income and on Capital” or the UN model and the latter derives from the OECD model. A central focus for the forum, therefore, was the basic building blocks used in the OECD model. In a series of presentations, **Mr. David Partington** of the Centre for Tax Policy and Administration, OECD, provided a comprehensive overview of the OECD treaty.

34 The primary objective of tax treaties, to eliminate double taxation, and the methods used to achieve this has not changed to any great extent over the past 50 years. However, the role played by the OECD *Model Tax Convention* in facilitating the negotiation of tax treaties and supporting the constant interpretation and application of tax treaties has expanded considerably. The OECD Model has made a significant contribution towards establishing the extensive network of over 3500 tax treaties aimed at removing direct tax obstacles and distortions to cross-border trade and investment flows by providing a respected model and extensive guidance on the interpretation and application of tax treaties. Mr. Partington’s presentation considered the role of tax treaties generally, the role of the OECD Model and the developments that have contributed towards the wider acceptance and evolution of the OECD Model.

35 Tax treaties aim primarily to minimize double taxation, but also aim to avoid excessive taxation, uncertain taxation and tax avoidance and evasion. They do this to remove tax obstacles and distortions to cross-border trade and investment flows and thereby maximize global wealth by ensuring an efficient global allocation of resources. Tax treaties achieve these objectives by:

- a.) eliminating the most common forms of juridical and economic double taxation;
- b.) eliminating or reducing some taxes that would otherwise be payable by foreign investors;
- c.) eliminating some forms of tax discrimination;
- d.) providing a standardized set of rules for dividing tax revenues between countries;
- e.) addressing tax evasion and avoidance;
- f.) providing a framework for settling tax disputes;
- g.) providing a stable tax environment to foreign investors; and

- h.) increasing the international competitiveness of the economy.

36 While most countries have unilateral provisions in their domestic law to support these objectives, they are usually found to be inadequate for eliminating double taxation because these rules do not address cases where more than one state considers the same person to be a resident and where the two states adopt overlapping source rules. Tax treaties deal with both of these problems by providing for residence of a single state through the residence tie-breaker and by providing common source rules.

37 Increased economic interdependence and economic cooperation after World War II increased the importance of measures for preventing double taxation, which was considered to be a serious obstacle to international trade and investment. In 1956, when the Organisation for European Economic Cooperation (OEEC) (the forerunner of the OECD) commenced its work on tax treaties, it recognized that early bilateral tax treaties had some degree of harmonization, but there were substantial differences between agreements bearing on the same matter. It also noted that early models, including the models developed by the League of Nations and the London and Mexico Models, were not fully and unanimously accepted.

38 With the success that the OECD Model Tax Convention enjoys today, it is hard to imagine the cloud of skepticism that hung over its birth and the uncertain future facing the work in the late 1950s. But perhaps the recognition, up front, of the difficulties facing the experts in achieving concrete results set the project off in a practical and focused direction, which turned out to be a successful approach. The OEEC ad hoc Committee of Experts on Taxation considered the best way forward was to develop general principles that could be applied in order to avoid double taxation by focusing on the treaties being concluded by OEEC Member and Associate Member countries.

39 When they were conceived, the roles of the OECD's Draft 1963 Model Double Tax Conventions and 1977 Model Tax Convention were primarily to:

- a.) facilitate bilateral negotiations between OECD Member countries and extend the network of double tax conventions to all member countries;
- b.) reach a desirable harmonization between their bilateral conventions for the benefit of taxpayers and national administrations;
- c.) harmonize double tax conventions in accordance with uniform principles, definitions, rules and methods;
- d.) clarify, standardize and guarantee the fiscal situation of taxpayers; and
- e.) facilitate the interpretation and enforcement of bilateral conventions along common lines.

40 Over the years the role of the OECD Model evolved to give it wider appeal and acceptance. It is difficult to pinpoint specific initiatives that have brought this about because it is more likely to have resulted from a combination of interlinked developments and initiatives. But it is clear that the focus today is more about ensuring the consistent and accurate interpretation and application of tax treaties than facilitating a network of tax treaties, because that network is now very extensive and established.

41 The greater acceptance by OECD member countries, non-OECD countries, business and the courts as the basis for negotiating, applying and interpreting tax treaties is probably a result of many interrelated factors including:

- a.) greater flexibility through observations, reservations and alternative provisions as a means of meeting different country needs without the need to revert to a watered down consensus or avoid issues altogether;
- b.) consistent quality of analysis and guidance;
- c.) the body of law developed by the courts confirming OECD interpretations;
- d.) the 1992 loose-leaf Model, which allows regular updates;
- e.) the OECD Model's responsiveness to change and ability to provide timely guidance on new developments and problems;
- f.) the expanded membership of the OECD bringing greater diversity and influencing the OECD's work;
- g.) its use as the basis of the UN Model;
- h.) the OECD becoming more outwardly focused through the organization-wide outreach program and benefiting from the work with non-OECD economies and their input;
- i.) the adoption of OECD Model provisions and interpretations by non-OECD economies;
- j.) tax policy reform, following globalization, moving towards lower tax rates on mobile capital (advocated by the OECD Model); and
- k.) the OECD consulting more widely on its tax treaty work.

42 In a follow-up presentation, **Mr. David Partington** compared the OECD Model and the UN Model. He was joined by **Mr. Michael Lennard**, Chief, International Tax Cooperation & Trade Section of the Financing for Development Office in the United Nations Department of Economics & Social Affairs, United Nations, N.Y. The two Models were compared against a live example, a treaty between two countries that were present in the conference.

V. DRAFTING DOMESTIC LAW TO ACCOMMODATE TREATY OBLIGATIONS AND ENTITLEMENTS: KIYOSHI NAKAYAMA

43 The successful implementation of international bilateral tax treaties requires careful alignment of domestic law to complement and support the treaty. **Mr. Kiyoshi Nakayama**, an Advisor in the Fiscal Affairs Department of the International Monetary Fund explained the relationship between domestic laws and tax treaties and the considerations that must be kept in mind when drafting domestic law to accommodate treaty obligations and entitlements. As a tax treaty reduces or exempts source country taxation, it is desirable that the relationship between a

tax treaty and domestic laws be clear to taxpayers, especially those in treaty partners, in order to facilitate the smooth application of treaty benefits.

44 While in some countries such as the U.S., France, Japan, and New Zealand, the relationship between treaties and domestic laws is clear, in others, it is not. Article 27 of Vienna Convention on the Law of Treaties (Vienna Convention) provides that “*A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.*” However, the U.S. Constitution provides that laws and treaties are in the same rank and its Internal Revenue Code (IRC) clarifies it. In other words, the “later-in-time” rule applies. For example, the branch profit tax introduced by the amendment of the IRC overrode previous treaties. Although the U.S. courts have been trying to avoid a treaty override as much as possible by interpreting a legislative intension, the country’s legal hierarchy poses unpredictable consequences to its treaty partners and their residents. On the other hand, the Japanese Constitution specifies that treaties prevail over domestic laws and New Zealand has clarified the supremacy of treaties in its tax law. In order to provide transparency and predictability to foreign investors, it is desirable to clarify whether tax treaties prevail over domestic laws in tax laws, unless the Constitution explicitly provides a rule.

45 There are two other important rules regarding the relationship between treaties, the “preservation clause” and “saving clause”. The preservation clause nullifies any treaty provisions that inadvertently take away benefits otherwise permitted by domestic law. The Japan-U.S. tax treaty from 2003 provides a useful example of a preservation clause. While self-evident, this principle is worth clarifying in a law or guidance in cases where a treaty does not have explicit provisions. The saving clause maintains the right of a contracting state to tax its own resident or citizen as if the treaty did not exist. This is also self-evident. However, given arguments in some countries as to the relationship between a controlled foreign corporation rule (CFC rule) and tax treaties, some treaties now have a provision clarifying that the CFC rule does not violate tax treaties. A CFC rule allows one country to look through a controlled company in the other jurisdiction and attribute the income of the controlled company directly to its shareholders, as if the company were a transparent entity.

46 Assuming that treaties prevail over domestic laws in a country and any further procedures other than the approval by Diet/Parliament/Congress are not required, why are domestic laws to implement a tax treaty necessary? If a tax treaty is self-explanatory, there is no need for implementing laws. Furthermore, as Article 3(2) of the OECD Model provides a rule on how to interpret terms not defined in a treaty, it is difficult and unnecessary to define all terms in a tax treaty. While the rule in Article 3(2) solves most cases, it should be kept in mind that undefined terms or terms defined in non-tax laws often lead to misunderstanding or abuse by taxpayers. Whenever a tax policy department foresees or encounters such cases, it should introduce a provision that defines the potentially problematic terms as part of the tax laws. Enacting such laws after a treaty has been concluded may require a discussion among competent authorities, and even, if necessary, a renegotiation of the treaty.

47 Most tax treaty provisions reducing or exempting source country taxation require residents of a treaty partner country to follow certain procedures. As with terminology, it is difficult and unnecessary to specify the details of these procedures in a treaty. Thus, domestic laws or regulations or other forms of guidance should set out the necessary procedures for applying for treaty benefits.

48 Needless to say, if treaty provisions clearly state the rights and obligations of taxpayers (treaty partner residents), such as the distribution of taxing rights between a resident country and a source country, or the non-discrimination clause, the treaty provisions directly apply.

49 In a law implementing tax treaties, all issues which require clarification and guidance should be considered, not only for the benefit of taxpayers or withholding agents, but also for tax officials. Examples of what should be included in a law implementing tax treaties are:

- a.) the definition of terms which may cause misunderstanding or lead to abuse;
- b.) procedures to apply for treaty benefits;
- c.) exchange of information;
- d.) assistance in the collection of taxes; and
- e.) mutual agreement procedures.

50 Above all, in relation to (2), the question of how to apply treaty benefits to hybrid entities is becoming more important, as failure to clarify this issue may lead to denying treaty benefits to legitimate residents of a treaty partner or to abuse by those who try to avoid taxation in both the resident country and the source country. In addition, in relation to (3), laws that enable tax authorities to provide requested information to their treaty partners regardless of domestic tax interest are also becoming more important, as the majority of countries have now committed to complying with the Global Forum standard on transparency and tax information exchange.

51 An important issue to be considered is the question of treaty shopping. Treaty shopping can be defined as the exploitation of treaty benefits by taxpayers who have little or no relationship with the treaty partner except as shareholders in corporations established in the territory of the treaty partner. The question is whether treaty benefits should be applied to a resident of a treaty partner who conducts a transaction solely for the purpose of avoiding tax liabilities.

52 Article 31 of Vienna Convention provides that “*a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*”. Given that one of the purposes of tax treaties is the prevention of fiscal evasion, such behavior may be construed as the abuse of the tax treaty and the application of treaty benefits should be denied.

53 There are various anti-treaty shopping provisions in tax treaties, including the beneficial owner concept, a general *bona fide* provision, an activity provision, and amount of tax provision, a stock exchange provision, limitation of benefits provisions, and provisions aimed at specific tax regimes or types of income. However, the problem is how anti-abuse provisions in tax laws such as a general anti-avoidance rule (GAAR) can be applied to a treaty shopping case where a treaty has no effective anti-treaty shopping provisions. In some countries, the general anti-avoidance provisions can apply to a treaty shopping case by virtue of the fact that taxes are ultimately imposed through the provisions of domestic law and abuse of tax treaty provisions can be regarded as the abuse of domestic tax law provisions.

54 It should be kept in mind that the denial of treaty benefits in the case of treaty shopping ultimately depends on court decisions or mutual agreement procedures. An alternative approach is the use of procedures that could have deterrent effects. For example, a certificate

of residence issued by tax authorities; a refund system; or a withholding tax system on entertainer companies could all act to deter treaty shopping or treaty abuse while allowing legitimate residents of treaty partners to enjoy treaty benefits.

55 In summary, given that the objective of tax treaties is to promote international trade and investment between treaty partners by eliminating double taxation, transparent and predictable application of the treaty is a key. Thus, tax policy makers should create laws to implement tax treaties that cover all necessary issues. At the same time, the tax policy makers should be mindful of the risks of treaty shopping and take necessary counter measures without imposing an unduly heavy burden on taxpayers.

VI. THAILAND'S EXPERIENCE IN INTERNATIONAL TAX TREATY NEGOTIATIONS: PATRICIA MONGKHONVANIT

56 **Ms. Patricia Mongkhonvanit**, Senior Tax Economist in the Bureau of Tax Policy and Planning of the Revenue Department of Thailand used the Thai experience to provide forum participants with an illustration of the factors that a negotiator takes into account when negotiating a tax treaty. The starting point is the domestic tax system which forms the base on which the treaty will apply.

57 In the fiscal year 2010 (October 2009 to September 2010), Thai Government revenue came from three main sources: tax revenue, revenue from state-owned enterprises and other sources. Tax revenue accounted for 90% of the total government revenue. The remaining was equally shared between revenue from state-owned enterprises and other sources.

58 Three Departments were responsible for collecting tax revenue. In fiscal year 2010, the Revenue Department collected 75% of total tax revenue, followed by Excise Department, 20%, and Customs Department, 5% respectively.

59 The Revenue Department collects six types of taxes. This includes three direct taxes: Personal, Corporate and Petroleum Income Taxes; and three indirect taxes: VAT, Specific Business Tax and Stamp Duty. The VAT is the most productive tax in terms of revenue, accounting for 39% of the total taxes collected in fiscal year 2010. Corporate and Personal Income Tax accounted for 34% and 17% respectively. Petroleum Income Tax accounted for approximately 8% of tax revenue and the remaining 2% included tax revenue from Specific Business Tax and Stamp Duties.

60 Individuals, Ordinary Partnerships and non-juristic body of persons, deceased persons and undivided estates that are Thai residents for tax purposes are subject to Personal Income Tax in Thailand for their income sourced in Thailand. An individual is considered to be a Thai resident if she or he spends more than 180 days in Thailand.

61 Income is sourced in Thailand if it is derived from employment or business carried on in Thailand, from the business of an employer residing in Thailand and from immovable property or other assets situated in Thailand. Foreign-source income is taxed only if such income is brought into Thailand within the same year that the income arises. Income of Thai residents is generally taxed at progressive rates ranging from 5% to 37%. However, some types of income are taxed at flat rates and taxpayers can opt not to include such income into their year-end tax returns. Examples of such income include dividends and interest, which are taxed at the rates 10% and 15% respectively. Capital gains realized on the sale of securities traded on exchanges

are exempt from taxation. However, capital gains from the sale of securities sold through “over the counter” trading are taxed at progressive rates.

62 In recent years, the government has used fiscal policy to stimulate the economy as well as to lower the tax burden for low-income earners. As a consequence, in 2008, the government exempted from tax net income of less than 150,000 Baht per year. Any income above the exempted amount is taxed in accordance with the rates stipulated under the Revenue Code. Non-residents are taxed only on income sourced in Thailand. Dividends derived by non-residents are taxed at 10% and other types of income sourced in Thailand derived by non-residents are taxed at 15%.

63 A company is considered to be a resident of Thailand if it is incorporated under the law of Thailand. Under the Revenue Code, a Thai incorporated company is taxed from its worldwide income at the rate of 30% of net profit. However, in recent years, the government has reduced Corporate Income Tax Rates for certain types of companies and/or businesses. Small and Medium Enterprises are taxed at progressive rates of 15%, 25%, 30%. Regional Operating Headquarters and offshore oil trading are taxed at concessional rates at 10% of net profits.

64 Non-resident companies doing business in Thailand are taxed at the rate of 30% of net profit in Thailand, and are also subject to 10% profit remittance tax of the profit remitted out of Thailand. Non-resident companies operating international transportation business in Thailand are taxed at the rate of 3% of gross income. Non-resident companies not doing business in Thailand but receiving income from Thailand are taxed at the rate of 10% in the case of dividends and 15% in the case of other income.

65 Petroleum Income Tax is the only tax law that is not in the Revenue Code. Petroleum Income Tax is imposed on any business carrying out petroleum exploration or production. While the law includes different rates for different activities, effectively businesses will bear the same relative amount of tax liability.

66 Thailand entered into its first tax treaty in 1964 with Norway. Up to October 2010, Thailand's DTA network comprises of 54 countries namely Indonesia, Laos, Malaysia, Philippines, Singapore, Viet Nam, PRC, Hong Kong, China, Japan, Republic of Korea, Bangladesh, India, Nepal, Pakistan, Sri Lanka, Bahrain, Israel, Kuwait, Oman, UAE, Uzbekistan, Mauritius, Seychelles, South Africa, Armenia, Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Luxembourg, Netherlands, Norway, Poland, Romania, Russia, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine, UK & North Ireland, Chile, Canada, USA, Australia and New Zealand. Thailand is currently negotiating treaties with 12 further countries and renegotiating 4 further treaties. There are 15 treaties waiting to be ratified or notified.

67 Each year, the Revenue Department selects 10 countries for treaty negotiations. The selected countries normally consist of new and negotiation-pending countries. Then, the list is sent to the Cabinet for approval. After receiving the approval, Ministry of Foreign Affairs will submit a request to the relevant countries. The negotiations will take place after the dates and venues have been agreed upon. After the negotiation has been concluded, the agreed treaty will be submitted to the National Assembly for approval. Once the treaty is approved by the National Assembly, the Ministry of Foreign Affairs will proceed with the enforcement process. The Revenue Department will announce any new treaty enforced through a press release, its website and the e-taxinfo service which is a free updated tax news emailed to subscribers.

68 Even though the Thai model is based on OECD and UN models, there are also departures to protect Thailand's interests. Thailand does not adopt Article 22, Capital; Article 27, Assistance in the Collection of Tax; and Article 29, Territorial Extension of the OECD Model. Most of articles comprise a combination of OECD and UN models. Key features of the Thai model that differ from the models are:

- a.) treaties only apply to taxes on income;
- b.) the definition of a person also includes all entities that are subject to taxation under the law of Thailand;
- c.) a person is treated as a resident of Thailand if it is incorporated under Thai law;
- d.) under the Business Profit Article, Thailand reserves the right as a source country to tax on gross income under domestic law if the taxpayer supplies inadequate information to calculate profits;
- e.) Thailand reserves the right as a source country to tax shipping transport at 50% of normal tax rate;
- f.) the definition of royalties also covers software, motion pictures and live broadcasting;
- g.) Thailand reserves the right as a source country to tax gains from the sale or transfer of shares or other securities;
- h.) Thailand proposes that the source country exempt Artists and Sportspeople if their visits are substantially supported by public funds, local authorities or a statutory body of the sending State;
- i.) Thailand proposes that the source country should exempt professors, teachers and researchers if their visits do not exceed two years, but not extending this exemption to research for the private benefit of a specific person;
- j.) Thailand proposes that any agreement reached under the mutual agreement procedure Article be implemented within time limit under the domestic law; and
- k.) Thailand proposes that the treaty gives rights to apply anti-avoidance rules under the domestic laws.

VII. THE PHILIPPINE EXPERIENCE IN INTERNATIONAL TAX TREATY NEGOTIATIONS: JAMES ROLDAN

69 **Mr. James H. Roldan**, Assistant Commissioner, Legal Service, Bureau of Internal Revenue, Department of Finance, Quezon City, The Philippines provided insights into the Philippine experience in international tax treaty negotiations.

70 The Philippines is a Southeast Asian archipelago composed of 7,100 islands (more or less, depending on whether it is high tide or low tide) with a growing population of approximately 95 million Filipinos. The country has a large agricultural base but has always encouraged foreign investments in export manufacturing/assembly or infrastructure related projects. Lately, investments have been heavy in the service sector such as in business process outsourcing and in tourism. The economy of the Philippines has been steadily growing in past years although there is still plenty of room for improvement. One of the key areas of improvement would be in increasing the quality and quantity foreign direct investments. While there are many

factors considered by foreign investors, one key consideration is the existence of bilateral tax treaties.

71 The existence of a bilateral tax treaty is a major consideration for a foreign investor because double taxation of income is avoided. The avoidance of double taxation makes a direct impact on profits of an enterprise. Thus, bilateral tax treaties are crucial for a comprehensive government program designed to attract foreign direct investments.

72 Currently, the Philippines has thirty-seven (37) bilateral tax treaties which are effective and in force. Seven (7) signed treaties are pending ratification with the Philippine Senate pursuant to Constitutional requirements. There are three (3) negotiated agreements which are pending signatures by respective authorities of each party.

73 In the Philippines, international tax treaty negotiation is primarily the responsibility of the International Tax Affairs Division of the Bureau of Internal Revenue (BIR). Usually, a government would communicate, through diplomatic channels, that it desires to have a tax treaty negotiation with the Philippines. The BIR would be tasked to make a determination of whether a treaty should be negotiated with that particular government. After a determination is made to enter into negotiation, a schedule for negotiation would be established.

74 The period prior to an impending tax treaty negotiation is spent in preparation for the actual negotiations. The appropriate clearance to negotiate is secured from the Executive Secretary. As far as practicable, a comprehensive study on the economy, policies and legal framework of the other country is made. The specific positions to be taken on certain tax treaty provisions are discussed and agreed upon. Logistical requirements such as venue, food and social functions are coordinated.

75 One tool which is helpful in tax treaty negotiation is the preparation of a model treaty which already embodies the ideal tax treaty provisions to be sought after. The model treaty can even embody provisions not found in the United Nations or the OECD models. The Philippines came out with a model tax treaty in 2005 and has been in use since then. A model tax treaty gives negotiations a head-start because an initial position is already taken and a counter-proposal can immediately be formulated even before the two parties get together.

76 The negotiation proper is the most exciting and stressful part of the process of creating a tax treaty. During a negotiation, both parties try to maximize their position and engage in one-upsmanship. However, in order to have a meaningful negotiation, both parties must exert effort to find the common ground through reason, logic and compromise, all the while, showing patience and diplomacy deserving between two respecting parties. Books and training workshops abound on the skills needed to be an effective negotiator. Negotiations can go on for several rounds although there were instances when only one round of talks was necessary for a complete negotiated draft.

77 After a final draft is made then execution, ratification and entry into force are the final steps to be taken. Execution of the agreement signifies agreement between those who affixed their signatures to the instrument but execution does not mean final consent. In the Philippine setting, the Constitution requires that for treaties to become effective, it must be ratified by two-thirds the Philippine Senate. Ratification by the Senate signifies final consent by the Philippine Government.

78 The Philippine experience in tax treaty negotiations much like in other countries is full of challenges. One of the problems encountered is budgetary constraints which make it difficult to reciprocate a visit to a country which had just visited the Philippines to pursue a round of negotiations. This situation delays the completion of a draft treaty. Changes in leadership also translate in changes in policies and priorities with treaty negotiation often losing ground to more pressing problems. Lack of competent personnel is also a problem because the good ones often end up going to greener pastures.

79 However, despite all the challenges, those involved of tax treaty negotiation and treaty implementation continue to serve and make the best with available resources. It is their effort and the effort of donor agencies with their capacity building programs which push forward the drive to have a complete and updated set of tax treaties. For those involved in the process, the experience has been quite rewarding many ways and hopes are high that, in the long run, having tax treaties in place will contribute to sustained and robust foreign investments.

VIII. IMPROVING CAPACITY TO COMPLY WITH INTERNATIONAL TAXATION STANDARDS: VICTOR VAN KOMMER

80 Responding to internationalization involves more than merely modifying tax laws to deal with cross-border transactions and entering into tax treaties to regulate the cross-border taxation. **Professor Victor van Kommer**, Director, Knowledge Centre, International Bureau of Fiscal Documentation (IBFD), Amsterdam, pointed out it also requires improving capacity to comply with international taxation standards.

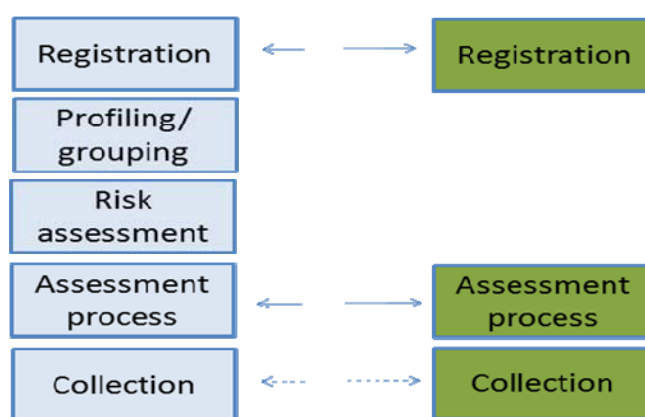
81 The past decades have witnessed an unprecedented liberalisation and globalisation of national economies. Countries have increasingly removed or limited controls on foreign investment and diminished foreign exchange controls. At the same time progress in information and communication technology has made the world a smaller place. As a result, business and financial activities take place in an increasingly borderless world.

82 Due to trade liberalization we have seen in the last decades significant reduced tariffs. For the less developed countries, this has translated to a loss of 30-50% of total revenue. A study of IMF indicated that they could only recover 30% and what they have done was merely a shift from import duties (on luxury goods) to domestic tax on goods and services that have also be paid by low income households. The developed countries (where the share of customs duties was anyway a tiny part of total revenues) were easily able to find other source (a small increase in consumption tax rates). Especially for small jurisdictions (Caribbean and Pacific Islands) the search for other sources of income means a necessarily introduction of VAT and income tax systems.

83 While business goes global, tax administrations remain confined to their respective jurisdictions. The exercise of sovereign powers, including tax verification, assessment and collection activities, is generally limited to a jurisdiction's territory. Thus, a tax official might only see a small part of the overall activities or investments of a taxpayer operating on a global basis if the official relies on domestic sources of information. As a result, tax administrations increasingly rely on co-operation with their foreign counterparts to more effectively administer their national tax laws. A key element of such co-operation is exchange of information. It is an effective way for countries to maintain sovereignty over the application and enforcement of their tax laws and to ensure the correct allocation of taxing rights between tax treaty partners.

Similarly, co-operation in collection assistance is increasingly viewed as an important tool in protecting tax revenue and increasing tax compliance.

84 However, in practice exchange of information and other forms of international cooperation turn out to be very complex and time consuming due to language differences and difficulties with identification of taxpayers (some countries not using TINs or postcodes) and differences in tax laws, processes and IT systems. Another problem is that the developed countries are hunting for information to fill in gaps in their information related to registration, assessment, investigation and collection processes. Only rarely do tax administrations exchange the type of information needed to fill in those gaps, namely information on the grouping of individual registrations, the risks regarding the total entity and the risks related to the tax planning of the entity.



85 Responses to requests for exchange of information are mandatory in tax treaties. The obligation to exchange information is not limited to information contained in the tax files held by a tax administration. Where requested information is not available in the tax files, the requested party must use its information gathering measures to seek to obtain the information from the taxpayer(s) or third parties. This may include special investigations or special examination of the business accounts kept by the taxpayer or other persons. Under paragraph 4 of Article 26 of the OECD Model Tax Convention whether or not the requested party has an interest in the information for its own tax purposes is irrelevant. Information must be provided even where the requested party does not need the information for the administration or enforcement of its own tax laws. There are a few exemptions to this general rule.

86 Any information received should be treated as confidential. The confidentiality rules apply to all types of information exchanged.

87 Increasing internationalization of business has a growing impact on the collection of taxes. Internationally operating companies can produce their goods and services anywhere in the world and they can keep their books and accounts at any place in the world. International traffic and the exchange of money, goods and services rapidly increase and intensify.

88 Tax administrations in response need to intensify their mutual co-operation not only in quantitative terms but also qualitatively. Multilateral tax auditing should be improved and intensified. To a certain extent this has happened especially within the European Union. A precondition for successful co-operation in this particular area is knowledge of tax audit

strategies and policies and audit procedures and techniques that are used by other Tax Administrations and also knowledge of the powers they have to gather information and to execute examinations and audits.

89 Despite its growing importance and the increased attention paid to it, there is still a long way to go before optimal cooperation among Tax Administrations is achieved. Especially discrepancies between legal systems, insufficient coordination among Tax Administrations and their sometimes inadequate organization, and the lack of clarity and timelines of the exchange procedures are the reasons why optimal cooperation is still a long way off.

90 Attention is also given to improving the technical aspects of exchange of information. An increasing number of countries are engaged in automatic exchange of information. Information suitable for automatic exchange is typically bulk information comprising many individual cases of the same type, usually consisting of details of income arising from sources in the supplying state where such information is available periodically under that state's own system and can be transmitted automatically on a routine basis. Automatic exchange of information requires standardization of formats to be efficient. The OECD has developed and continues to develop standards for automatic exchange taking into account the latest technological developments. The new format is called the Standard Transmission Format (STF) and is based on extensible mark up language (XML), a document mark up language widely used in today's information technology for its many advantages.

91 Less developed countries face a number of challenges that limit their tax capacity. These include economic factors (like the presence of a large informal sector and a large share of agriculture), social and political factors (poor education levels, poverty, bad governance) and size issues (small jurisdictions such as Caribbean and Pacific islands) that limit an effective execution of the legal system (the tax authority cannot be anonymous because everyone knows each other). This limits the amount of tax revenues to be raised with conventional taxes: a modern VAT with a high registration threshold – essential if the tax is to operate by means of self-assessment – necessarily has a limited number of (formal) taxpayers; the scope of personal income taxes is also limited; company income taxes are typically complemented by a presumptive regime to tax smaller firms, an approach that increases administrative costs; and import duties are likely to be lower in the near future due to international and regional trade integration. A variety of factors often ensure that those people paying taxes do not pay much. The reasons may lie in explicit policy choices (e.g., investment incentives), evasion and avoidance (illicit flows) and in corruption. A tax agenda that addresses political economy challenges – or governance aspects – is at the moment far from complete. The challenge is to tax more people by at least a bit, and to do so in a visible way, without undue administrative costs and taking into account technical aspects of specific tax instruments. This should be seen particularly in the face of administrative issues (lack of technical and intellectual as well as physical capacity) being, arguably, the most prominent challenge in taxation in developing countries.

92 The solution lies in tackling the problem from a holistic perspective, considering not only the structuring of effective information systems, but such fundamental aspects as:

- a.) Sufficient political support and the formal willingness to generate change;
- b.) Maximum revision and simplification of the country's tax system;
- c.) A clear, precise tax legislation and more detailed guidelines, commentaries and secondary legislation;
- d.) A tax administration with technical, administrative and financial autonomy and

resources for its efficient management; and

- e.) More domestic change of information between the tax authorities, customs and other public enforcement agencies;

93 Development and professionalization of human resources and assurance, their continuity and permanence are totally independent from political changes.

94 What are the problems in many countries (especially developing countries) that made it so difficult to organize the combat against tax avoidance and evasion? Below are some examples that illustrate the failure of many governments to collect the proper tax revenues:

- a.) Governments are forced to introduce tax legislation that is in favor of stimulating the domestic economy, but which has the side effect of making it easier for illicit transactions to disappear from the tax collector's radar;
- b.) The tax legislation is too complex. Thanks to all the efforts of international organizations and the flow of accompanied lawyers and other consultants, the legal system in many countries has drifted away from the necessary simplicity as one of the elementary building blocks for an executable tax system;
- c.) Especially in developing countries and countries that have by nature a small jurisdiction (islands in the Caribbean and the Pacific) the capacity at three levels (policy, legislation and administration) is extremely limited and vulnerable. The world of international taxation may be greater than the countries' absorption capacity for new rules;
- d.) The tax base is not always broad enough due to the political will to introduce or to protect all kinds of tax exemptions and tax holidays. Normal investment is not merely based on tax incentives. Countries adopting tax incentives run the risk of attracting investments that would have come anyway but with less revenue for the government;
- e.) Tax administration has to put more efforts into understanding business decisions and have to follow the flow of capital. Intelligence and research are elementary to understand the economy (and its impact on taxation) better. Tax administrations have to make quick decisions between compliant taxpayers (fast treatment and customer service are adequate) and non-compliant behavior (including aggressive tax planning and tax treaty shopping (in depth auditing, research and investigation techniques are required). However, the tax administration has to avoid a bureaucratic behavior (unnecessary formalities and delays);
- f.) The lawmakers do not appreciate how tax incentives can be used to shelter tax haven behavior.

95 Two further shifts might be considered to help the less developed countries. First, we have to consider introducing provisions for cost sharing and even revenue sharing. If we recognize that information has a value, we can share the outcome of this information and enable the less developed countries to invest in the strengthening of their capacity. This is a more effective and transparent way to provide support than the use of foreign aid programs.

96 Second, we have to abandon the mentality that the problem is somewhere else. We have to consider genuine sharing of information instead asking for information to fill the gaps in our own data and to start with simultaneous audits and even better joint audits. The less developed countries will get than real experience and training on the job at the operational level.

IX. JAPAN'S POLICY FOR INTERNATIONAL TAXATION: TADASHI YOKOYAMA

97 Japanese international taxation rules have been altered in both 2009 and 2010. Conference participants were able to learn of these developments as well as shifts in Japanese treaty policy during the presentation of **Mr. Tadashi Yokoyama**, Director, International Tax Policy Division, Tax Bureau, Ministry of Finance, Tokyo.

98 A significant change was the shift in the method for relieving double taxation on dividends received by Japanese companies from foreign subsidiaries. Until 2009, Japanese tax law subjected the dividends to tax but provided a foreign tax credit against the Japanese tax liability for any withholding tax imposed on the dividends and for any company tax paid by the subsidiary on the profits from which the dividends were paid. In 2009 the direct and indirect credits were replaced with an exemption for dividends from foreign subsidiaries.

99 To qualify for the new exemption system, a company must hold a 25% or greater interest in the subsidiary. This rule will cover 95% of dividends paid by overseas subsidiaries. Foreign subsidiaries of Japanese firms hold 20 trillion yen in retained earnings. It is hoped that the new rule will encourage companies to repatriate these retained earnings to parent companies in Japan.

100 Other types of foreign source income remain taxable to Japanese residents with a foreign tax credit for any tax levied in the source country.

101 The second major change to Japanese international tax rules reviewed was a modification of the country's "controlled foreign corporation" (CFC) rules. Under the CFC system, the Japanese tax authority will "look through" a foreign company located in a low tax jurisdiction and controlled by Japanese shareholders and attribute an appropriate share of the foreign company's profits to the controlling shareholders as if they had derived the income directly, without the interposed company.

102 In 2010, the definition of a low tax jurisdiction was changed from a jurisdiction in which the controlled company faced a tax rate of less than 25% to a rate of less than 20%. A new exemption from the rules was adopted for a regional headquarters.

103 Japan has concluded 48 tax treaties, applicable to 59 countries. A significant change in treaty policy is the new approach taken by Japan to "tax sparing", a concessional system that allows Japanese companies to claim credits for tax forgone by a developing country treaty partner by way of a concession or tax holiday to attract new investment. Japan formerly agreed to tax sparing in its treaties. It will now agree to a tax sparing treaty provision only if the sparing provision has a specified expiry date (a so-called "sunset clause"). Japan will not consider any adjustment to the provision to accommodate any changes to the host country's incentives.

104 New Japanese treaties contain a mutual agreement procedure that provides for arbitration in the Japanese competent authority and partner foreign authority are unable to reach an agreement on the application of a treaty provision to a taxpayer.

X. THE OECD'S ROLE IN EXTENDING THE DIALOGUE ON INTERNATIONAL TAXATION: YOKU YAMAZAKI

105 A common starting point for negotiators sitting down to negotiate a new bilateral tax treaty is the OECD Model treaty and tax officials are aware of the OECD for this reason. However, in addition to sponsoring a Model treaty, the OECD carries on a range of other activities to support countries designing responses to international tax issues. The OECD's activities in this respect were described by **Mr. Yoku Yamazaki**, Deputy Head, Centre for Tax Policy and Administration, OECD, Paris.

106 Mr. Yamazaki introduced a presentation on the OECD's broader role with a short history of the organization. The OECD evolved from a body focusing on the interests of post-war recovering economies in Europe to one seeking to foster sustainable economic growth in member countries. It now looks beyond its 33 member nations to include the interests of non-member developing economies through ongoing accession discussion and "enhanced engagement".

107 One of the OECD's important tasks is that of data collection. The collated data can be used by tax authorities to conduct comparative analyses.

108 Following a brief introduction to the OECD in general, Mr. Yamazaki focused on the work of the Committee on Fiscal Affairs (CFA), one of more than 20 Committees at the OECD. The CFA is responsible for tax policy and administration and comprises eight subsidiary bodies or structures. The work of many of these bodies extends to non-OECD economies. The OECD's motives for reaching out to non-members are two-fold – first, to provide non-OECD economies assistance with the development of their tax systems; and second, because the tax guidelines developed by the OECD will only operate effectively if they achieve global acceptance.

109 Another OECD initiative of particular value to tax officials in charge of tax treaties from non-member nations is the development of a tax treaty website providing a basic description of the practical effect of the provisions of the OECD model tax treaty and a summary for each Article in the model.

110 After noting the world wide focus on international tax evasion and the increased role of taxation for state-building, Mr. Yamazaki introduced the twin pillars of the OECD's outreach activities. One is a global relations program which includes annual events, particularly training programs, available to non-OECD economies either multilaterally, regionally or bilaterally. Since the early 1990s, the OECD has held over 800 events with non-OECD economies with around 20,000 tax officials attending the events. Over 70 events were held in the current year. Many of these were based on the OECD's multilateral tax training centers in Austria, Hungary, Korea, Mexico, and Turkey.

111 Individual countries have been getting keen on hosting multilateral events based on OECD presentations. In East Asia, Malaysia hosts eight events a year; Thailand is going to host the events on taxation on financial instruments; and the Philippines will hold high-level tax conference. In central Asia, Azerbaijan is keen on becoming regional focal point for training of tax officials.

112 OECD events for non-members normally involve a secretariat expert or course leader, experts from OECD member countries, and participants from non-OECD members in a multilateral environment. The primary intention is to promote dialogue. Events commonly last a week. Flexibility of contents and formats is one of the characteristics of OECD events. The door to these events is open to every country in the world. While noting it would be a great challenge to organize, Mr. Yamazaki suggested there would be many benefits from a Pacific island country hosted multilateral event.

113 To ensure the continued relevance of the OECD's programs, the organization seeks event evaluations by participants and conducts impact surveys. An advisory group for cooperation with non-OECD economies provides further guidance. The topics cover a variety of important taxation topics.

114 Another pillar of OECD activities is its tax and development program. This program is a joint initiative between the CFA and another OECD committee and is more development-oriented than the existing outreach program. Four sub-groups were organized to deal with State building, transparency and exchange of information, reporting of financial data by multinational enterprises, and transfer pricing.

115 Subgroups will meet in November and December and an informal task force is supposed to be held in the first quarter of 2011. The secretariat is currently preparing documents for the next sub-group meetings. Mr. Yamazaki emphasized the importance of development of guidance and models relevant to and effective for developing countries.

XI. INTRODUCTION TO AND SUMMARY OF THE MAIN PROVISIONS OF THE UN TAX TREATY IN THEIR CONTEXT: MR. MICHAEL LENNARD

116 **Mr. Michael Lennard**, Chief, International Tax Cooperation Section of the Financing for Development Office in the United Nations Department of Economics & Social Affairs, United Nations, New York, provided participants with an overview of the second model treaty reviewed at the forum, the United Nations (UN) model tax treaty.

117 He noted first of all that the issue of Double Taxation Agreements (DTAs) involved some special issues for Pacific Island Developing Countries (PIDCs). For many, such DTAs were not required at this stage, but even in such a case, some knowledge of what they offered, did not offer, and required, would at the very least help in briefing internally as to whether or not they were appropriate.

118 Mr. Lennard noted reasons why DTAs might be sought, including (i) showing that a country was, in a non-partisan fashion, "open for business", and doing so in a way that, from a potential investors point of view, was not as subject to the vagaries of who was in power at the time, and (ii) helping counter tax evasion, especially by providing for exchange of tax information. He pointed out, however, that other domestic law and administration reforms (e.g., reducing unnecessary compliance costs) could help send the right signals and help address evasion and avoidance, and were important whether or not DTAs were entered into.

119 Sometimes a Tax Information Exchange Agreement (TIEA) might be an alternative to a DTA if exchange of information is the real issue for a country, though it was probably unlikely that a country represented at the conference would be seeking a TIEA of its own accord rather than a comprehensive DTA because of its need for information exchange. In effect, a TIEA is

more likely to be with countries wanting access to information held by the PIDC. A TIEA would not provide the investment promoting aspects of “comprehensive” DTAs, and when agreeing to a TIEA, a country should bear in mind that it might be giving the other country one of the few benefits it saw in a DTA, without obtaining the wider benefits of a DTA for the PIDC.

120 Both the UN and OECD Models would benefit more from injecting the “realities” of PIDCs in their work, particularly the costs of complexity, which had the potential to widen the gaps of information and skills between bigger and smaller countries and between large corporates and small administrations.

121 A practical issue is the difficulty in getting on the tax treaty negotiation program of other countries and the importance of conveying the idea that a DTA suitable for both countries could be negotiated quickly, preferably in one round. Sometimes, especially with regional countries, placing the DTA in the wider context of country relations might help convince the Ministry of Foreign Affairs of the desirability of a treaty.

122 The lack of capacity building on basic negotiating techniques internationally is regrettable. While guidance on treaty negotiation generally is available, it did not usually address in a systematic way the issue of how to negotiate from a position of apparent weakness.

123 There are well recognized techniques of negotiating from such a position, including recognizing and leveraging a smaller country’s strengths and the other side’s weaknesses. One key would be in leveraging the fact that regional developed country partners in particular have an interest in helping development by encouraging investment without depriving the budget of taxes needed for public infrastructure, rather risk the possibility of a PIDC falling into difficulties as a country or becoming long-term aid dependent. Sometimes, a PIDC might link a DTA with other negotiations of interest to the other country or use an upcoming high level visit as a way of making things happen.

124 A group of smaller states working together could greatly improve their leverage, as well as reduce the chance of them being played off against each other. Negotiating with several countries in the region together, or in close proximity, might also be attractive to potential negotiating parties. A regional treaty might be a possibility at some stage. Finally on this point, Mr. Lennard noted that connecting with the persons in another country, who proposed a DTA with, might ensure the PICD’s needs and expectations were understood better and improve the chances of a fair outcome.

125 The United Nations, as the successor body to the League of Nations, has a long lineage in dealing with international double taxation. The work of the League of Nations in this area began in 1921 and ultimately led to the Model Conventions of Mexico (1943) and London (1946). The Mexico and London Models were very influential on the terms of bilateral tax treaties, but were not complete in their coverage or consistent in their approaches. The Fiscal Committee invited the UN to review the two models when it took over the League’s work after the end of World War Two. It suggested this should be done in a balanced forum with expertise from both capital importing and capital exporting countries – a characteristic the UN tax work retains to the present.

126 The UN continued the League of Nations work after the war with its Fiscal Commission, but the work lapsed in the mid 1950s, and the OEEC, the precursor organization to the OECD began to take up a role in this area. The OEEC adopted its first Recommendation concerning double taxation on 25 February 1955 and in 1963 the OECD Fiscal Committee presented a final

Report entitled “Draft Double Taxation Convention on Income and Capital”, which was adopted as the first OECD Model. That Model has been updated with increasing regularity since 1977, with the latest version being the 2010 version.

127 In 1967, the UN re-entered the field on international tax issues, and the UN Secretary-General set up the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries in 1968. The Group of Experts completed the formulation of guidelines for the negotiation of bilateral tax treaties between developed and developing countries in the course of seven meetings, from 1968 to 1977. The guidelines were contained in the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* published in 1979. That Manual was revised in 2003, and is currently being further revised. The Manual gives some extra background to the UN Model and its practical application. The 2003 version is freely available on the UN tax website: <http://www.un.org/esa/ffd/tax/index.htm>.

128 The Group of Experts also worked on a UN Model Double Tax Convention, based on the 1977 OECD Model Double Taxation Convention. They adopted a draft Model in late 1979 which was published in 1980 as the *United Nations Model Double Taxation Convention between Developed and Developing Countries*.

129 In the 1990s, the renamed Ad Hoc Group of Experts on International Cooperation in Tax Matters recognized that significant changes had taken place in the international economic, financial and fiscal environment, and noted the changes made to the OECD Model since the 1980 UN Model was published. Consequently, the Group of Experts proceeded with the revision and update of the UN Model and the Manual. This led to a new version of the UN Model published in 2001 <http://www.un.org/esa/ffd/tax/index.htm> and the 2003 version of the Manual mentioned above.

130 The Group of Experts was upgraded in 2005 within the UN System by conversion into a Committee structure. Formally this means that it now directly reports to the UN Economic and Social Council (ECOSOC). In practice it means tax issues have a higher status in the UN System, and that the Committee now meets every year rather than every second year.

131 The work of the current Committee and the place of tax work in the UN system can only be properly understood in the context of the International Conference on Financing for Development held from 18-22 March 2002 in Monterrey, Mexico (the Monterrey Conference). This UN-hosted conference on key financial and development issues attracted 50 Heads of State or Government and over 200 ministers as well as leaders from the private sector, civil society and all the major intergovernmental financial, trade, economic, and monetary organizations.

132 As the culmination of a four-year preparatory process, the Conference adopted the “Monterrey Consensus”, in which developed, developing and transition economy countries pledged to undertake important actions in domestic, international and systemic policy matters. In December of 2002, the General Assembly set in motion a detailed follow-up intergovernmental process, as called for in the Consensus, to monitor implementation and carry forward the international discussion of policies for financing development. The Assembly also called on the Secretary-General to establish a standing secretariat to support the process. The Financing for Development Office was then created in the Department of Economic and Social Affairs (DESA). Because of the obvious linkages between tax cooperation, including the development and maintenance of the UN Model, and the development of country economies, a

very small Secretariat for the Tax Matters Committee is stationed in New York – in the Financing for Development Office of the UN Department of Economic and Social Affairs.

133 A major follow up conference was held in Doha, Qatar from 29 November to 2 December 2008 and it further confirmed the need for strengthening international cooperation in tax matters to mobilize domestic resources.

134 The Committee itself is composed of twenty-five members nominated by governments but selected by the Secretary-General of the UN and acting in their personal capacity. The selection is made to reflect not just the individual expertise of candidates, but also an adequate equitable geographical distribution, representing different tax systems, and bearing in mind the special developing country focus of the UN tax work. The term of office for the current iteration of the Committee is four years, finishing at the end of June 2013.

135 At the time of the forum, the Committee was composed of experts from 15 developing countries, Morocco, South Africa, Nigeria, Senegal, Ghana, China, India, Pakistan, South Korea, Egypt, Barbados, Chile, Malaysia, Mexico and Brazil; and ten developed country experts from the USA, Germany, Belgium, Italy, Spain, New Zealand, Bulgaria, Norway, Switzerland, and Japan. Note that for UN purposes Mexico and South Korea are classed as “developing” – essentially by their choice.

136 The role of *non*-Members of the Committee in the UN Tax work should not be underestimated, however. The Annual Session of the Committee, which is always held in Geneva (18-22 October in 2010), is attended by many representatives of “Observer” Governments and by many representatives from academia, business and non-governmental organizations. Those representatives can participate freely in discussions and some are represented in the subcommittees and working groups of the Committee that do so much of the substantive work. It is vital for the success of the Committee’s work that it finds wide acceptance across the wider UN membership as a whole, and that it takes into account the relevant views of other “stakeholders” in the UN tax work, so this opportunity for wider participation in the Committee’s work is ultimately important for the quality, relevance and acceptance of that work.

137 The Committee’s Mandate is a very broad one, covering the following:

- a.) reviewing and updating the UN Model Double Taxation Convention and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;
- b.) providing a framework for dialogue with a view to enhancing and promoting international tax cooperation among national tax authorities;
- c.) considering how new and emerging issues could affect international cooperation in tax matters and develop assessments, commentaries and appropriate recommendations;
- d.) making recommendations on capacity-building and the provision of technical assistance to developing countries and countries with economies in transition; and
- e.) giving special attention to developing countries and countries with economies in transition in dealing with all the above issues.

138 The Committee has only very limited dedicated resources (essentially covering its Annual Session in Geneva each year) and a very small Secretariat supporting it, despite this broad mandate, and the issue of what resources should be devoted to tax issues in the UN remains an oft-discussed and still contentious matter, with the Committee regularly calling for greater resourcing to meet its broad mandate, but with the matter still unresolved within the UN.

139 In that context, the work of the Committee has focused on updating the 2001 UN Model (projected for 2011) and the 2003 Manual, to deal with modern conditions and tax treaty developments. In view of the Committee's focus on updating the UN Model Tax Convention, it is useful to briefly note the differences between the UN Model Tax Convention and its main "rival", the OECD Model. Both the UN and OECD Models are designed to encourage investment by preventing double taxation of profits. Such investment helps the development process in developing countries, particularly through the transfer of resources, managerial and administrative expertise and technology to the developing countries, the expansion of productive capacity and employment in those countries and the establishment of export markets.

140 Avoiding double taxation gives an encouraging climate for such investments, and although domestic laws could achieve the same thing, international double tax treaties ensure a coordinated approach as between two countries, and also give a public stamp and a greater solemnity to the promises of a country and make any "backsliding" in investment promises an international matter, legally as well as politically.

141 The OECD work rests on the same general principles, and the main reason for the existence of two models is a difference, in certain cases, about where the balance of source country and residence country taxation should lie in avoiding double taxation. In international tax law, unmodified by tax treaties, both the "source country" of the investment profits (the host country of the investment) and the "residence country" of the investor may tax the profits of the investment, so to avoid double taxation, at least one of the countries must yield that taxing right, as noted above. Since, under the credit or exemption Article of tax treaties, the residence country must at least give a credit for taxes paid in the other country, the residence country will only be assured of full taxing rights if the source country agrees that it will not be allowed to tax that same item of income, otherwise the residence country can only be assured of being able to tax to the extent that its tax on the profits exceeds that of the source country.

142 It follows that the real issue in tax treaty negotiations is generally whether, in respect of particular income profits or gains, the source country will relinquish its taxing rights. The main differences between the two Models are as to the extent of this relinquishment of taxation rights by the source country. Traditionally it has been said that the OECD is more of a "residence country" model (therefore reducing source country taxing rights and being generally preferable to capital exporting countries) and the UN Model is a more "source country" oriented model, generally preferable to host countries of investment.

143 That is still a fair assessment, although it has to be recognized that there is a certain "fuzziness" about this distinction, and about the interests and preferences of particular developed and developing countries. The UN Model recognizes the benefits of granting an attractive investment climate, but that source countries will often, as a matter of inter-nation equity, expect that they may tax the profits from such investments to finance infrastructure to encourage other investments, schools, hospitals and other programs as part of the countries chosen framework for sustained development.

144 The main differences between the Articles in the two Models flow from the general difference of the more source country orientation of the UN Model. There are, of course, further differences between the Commentaries and in the alternative provisions found there. The main differences in the Articles can be expressed in a tabular form as follows:

Provision	UN Model – Main Differences from OECD Model
Permanent Establishment (PE): Article 5	<ul style="list-style-type: none"> ⇒ Six month duration test for building and construction PEs (paragraph 3 - as compared with OECD twelve month test) and express coverage of supervisory activities; ⇒ Services provision deemed a PE if furnished by employees or others for over 6 months (paragraph 3(b)); ⇒ Delivery omitted from paragraph 4 - not treated as ancillary; ⇒ Larger scope for a dependent agent (DA) PE in UN Model – covers cases where DA regularly maintains a stock and makes deliveries from it (paragraph 5(b)); ⇒ Insurance – deemed PE for collecting premiums or insuring risks (paragraph 6); and ⇒ “Independent” agent actions may create a PE if devote nearly all their time with a client and not dealing on arms length basis (paragraph 7).
Business Profits: Article 7	<ul style="list-style-type: none"> ⇒ “Limited Force of Attraction” in UN Model - extension of source country right to tax income from business activities in the country (including sales) similar to that of the permanent establishment (paragraph 1); ⇒ Limitation of deduction of amounts paid by the permanent establishment to its head office (e.g. payments for patents etc or repayment of monies lent by a bank to its PE) (paragraph 3); and ⇒ Whether mere purchase of goods for Head Office constitutes a PE is left for negotiations – footnote to Article. ⇒ New OECD Article 7 not adopted by the UN.
International Shipping: Article 8	<ul style="list-style-type: none"> ⇒ UN Model's alternative “B” (limited source country taxation of international shipping that is “more than casual”).
Associated Enterprises: Article 9	<ul style="list-style-type: none"> ⇒ Adjustment not required in UN Model if final court ruling that one of the parties has engaged in fraud (paragraph 3).
Dividends: Article 10	<ul style="list-style-type: none"> ⇒ Maximum rate applicable not specified in UN Model– left to negotiation.
Interest: Article 11	<ul style="list-style-type: none"> ⇒ Maximum rate applicable not specified in UN Model, and it has a modification in paragraph 4 to reflect the “limited force of attraction rule” in Article 7.
Royalties: Article 12	<ul style="list-style-type: none"> ⇒ UN Model provides for a limited right of taxation for the country of source – paragraph 1 with an accompanying source rule at paragraph 5; ⇒ NB- OECD Model provides exclusive residence country taxation of royalties, though almost half of OECD countries have “reserved” on this aspect of the Model; ⇒ Maximum rate applicable in UN Model not specified (paragraph 2); ⇒ UN Model retains “equipment royalties” in paragraph 3 rather than them being dealt with under Article 7; and

	⇒ UN Model has a modification in paragraph 4 to reflect the “limited force of attraction rule” in Article 7.
Capital Gains: Article 13	⇒ Differing source taxation rights over shares in property-rich companies in UN Model - it does not include property-rich but applies to trusts, partnerships etc as compared with OECD Model – although that allows a broader provision at paragraph 28.5 (paragraph 4); and ⇒ Source country taxation of shares if holding is over an agreed threshold in UN Model (paragraph 5).
Independent Personal Services: Article 14	⇒ Deleted from OECD Model and independent services now treated under Article 7 –business profits; and ⇒ Will be retained in the UN Model, but with an option for deletion mentioned in the Commentary..
Directors and High Level Managers: Article 16	⇒ UN Model covers the activities of not just directors, but also high level managers.
Pensions and Social Security Payments: Article 18	⇒ Two alternatives. Alternative A is similar to the OECD Article (residence country taxation only) but a specific provision provides source country-only taxation for social security type payments; and: ⇒ Alternative B allows source country taxation also if the payment is made by a resident of that country or a permanent establishment situated in the source country. Note that the OECD Commentary acknowledges that some countries will seek source state taxation in their treaties.
Students: Article 20	⇒ OECD Model explicitly refers to business trainees as well as business apprentices.
Other Income: Article 21	⇒ Special provision in UN Model that income of a resident of a Contracting State not dealt with in other articles and arising in the source country may also be taxed in that source country (paragraph 3).
Article 25: Mutual Agreement Procedure	⇒ UN Model Article specifies the process in more detail in paragraph 4. ⇒ Paragraph 5 in 2008 OECD Model provides for mandatory arbitration (note the opt-out footnote, however). Arbitration is one aspect of the UN consideration of improving dispute resolution; there may be special issues for developing countries.
Article 26 Exchange of Information	⇒ OECD 2005 changes in effect adopted for the next version of the UN Model..
Mutual Assistance (New) Article 27	⇒ No equivalent provision in 2001 Model, but OECD type provisions and almost identical Commentary adopted by UN Committee in 2006 for inclusion in next version of UN Model.

XII. TRANSFER PRICING: RECENT DEVELOPMENTS IN TRANSFER PRICING: MICHAEL KOBETSKY

145 **Dr. Michael Kobetsky**, a Senior Lecturer in the Melbourne Law School at the University of Melbourne and a Taxation Fellow in the Faculty of Law at the Australian National University provided a comprehensive overview of the use of double tax treaties to address transfer pricing issues.

146 The globalized international economy, in which intra-group transactions are predominant, provides multinational enterprises with significant tax planning opportunities. Multinational enterprises have the capacity and incentive to shift profits between jurisdictions to take advantage of differences between national company taxes. In response, governments in developed and developing countries are pursuing tax revenue from cross-border trade between associated enterprises to protect their domestic tax bases. Multinational enterprises have to deal with demands from the various jurisdictions in which they operate because national tax agencies implement measures to protect their revenue from cross-border trade between associated enterprises. Multinational enterprises often incur significant costs in complying with tax rules and at times are subject to double taxation in situations in which relief is unavailable.

147 Transfer pricing manipulation to shift profits between jurisdictions is one of the tax avoidance techniques that can be used by multinational enterprises to minimize their overall level of taxation. The transfer pricing policies of multinational enterprises have an effect on the taxable profits or losses that they report in the various countries in which they carry on business. The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Transfer Pricing Guidelines) provide measures to counter transfer pricing manipulation to ensure that each jurisdiction in which a multinational enterprise carries on business receives an appropriate amount of revenue from cross-border intra-group trade. The Transfer Pricing Guidelines are premised on the arm's length principle that controlled transfer prices should reflect prices used in uncontrolled transactions between unrelated entities. Transfer pricing measures based on the Transfer Pricing Guidelines have been enacted in the domestic law of many jurisdictions. The associated enterprises article of the tax treaties of these jurisdictions usually reflect the associated enterprises article of the OECD Model or UN Model, which are similar. Nevertheless, transfer pricing is an area in which there are challenges for both tax agencies and multinational enterprises, as there is no single rule for determining the right transfer price; transfer pricing is an art not a science. The challenge transfer pricing poses for tax agencies is tax avoidance, and the OECD has stated that "transfer pricing is where the big bucks lie." Transfer pricing enforcement by tax agencies creates uncertainty for taxpayers, with the risk of adjustments, penalties and the potential for unrelieved double-taxation.

148 A key theme of this presentation was that emerging all countries need consider enacting and enforcing transfer pricing rules to ensure that their tax bases are protected when enterprises operating within their countries engage in cross-border transactions with associated enterprises. Transfer pricing manipulation provides multinational enterprises with tax avoidance opportunities to reduce their overall tax liabilities by shifting profits from higher tax jurisdictions to lower tax jurisdictions. Conversely, transfer pricing manipulation may also be used to shift profits into higher tax countries to use tax benefits such as imputation credits for shareholders or tax losses. Transfer pricing enforcement by some jurisdictions may encourage multinational enterprises to use transfer prices in favor of those enforcing jurisdictions to minimize risks of adjustments and penalties. The presentation outlined the motivations for associated

multinational enterprises to engage in international profit shifting through transfer pricing manipulation.

149 The Transfer Pricing Guidelines provide internationally accepted measures to counter transfer pricing manipulation. Dr. Kobetsky explained the OECD transfer pricing measures and provided examples first of how to apply the three traditional transaction methods set out in the guidelines: comparable uncontrolled price method, resale price method and cost plus method. He then illustrated the two transactional profit methods: the profit split method and the transactional net margin method. Transfer pricing principles in the OECD Model and UN Model are based on the arm's length principle, i.e., Article 9 (the associated enterprises article) of these models, treats associated enterprises as separate entities operating at arm's length. Under the arm's length principle, the transfer prices for transactions between associated enterprises must reflect the prices that independent entities would have used for similar transactions. The OECD has given significant attention to transfer pricing, centered on the arm's length principle, and in 1995 it issued the Transfer Pricing Guidelines. The most recent version of the Transfer Pricing Guidelines was published in 2010.

150 Dr. Kobetsky explained that one of the major changes in the 2010 version of the Transfer Pricing Guidelines was giving the transactional profit methods equal status with the traditional transaction methods. Previously the transactional profits methods could only be used a last resort if the traditional transaction methods could not be used.

151 Under the arm's length principle, the associated enterprises in an international company group are treated as separate entities dealing at arm's length with each other. Several rationales have been advanced as the basis for the use of the arm's length principle for transfer pricing. In an open market, companies considering a potential transaction are assumed to act rationally, and to evaluate alternative transactions to determine which is the most profitable type of transaction. Under the arm's length principle, intra-group transactions are compared to transactions between unrelated entities to determine acceptable transfer prices. Thus, the marketplace comprised of independent entities, is accepted as the measure for verifying whether transfer prices for intra-entity or intra-group transactions are acceptable for tax purposes.

152 A persuasive argument in support of the arm's length principle is that if it is used by most jurisdictions, the risk of double taxation will be minimal. Double taxation may still occur, despite the use of the arm's length principle, if one tax agency adjusts an international enterprise's transfer prices and the two countries do not resolve any consequent dispute. While it is relatively easy to describe the arm's length principle, establishing guidelines on the practical application of the principle is a challenging task given the difficulty of finding reliable comparable transactions.

153 Rules based on the arm's length principle are becoming increasingly difficult to administer. First, transfer pricing audits must be done on a case-by-case basis and may be complex and costly tasks for both the tax agency and the taxpayer, especially given the large volume of transactions that potentially may be examined. Second, the lack of comparable prices results in complexity because of the need for a tax agency to examine the facts and circumstances of each case to determine what it considers to be acceptable transfer prices. Realistically, tax agencies are only able to examine a limited number of cross-border transactions.

154 Article 9(1) of the OECD Model provides that where “conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to any one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.” This provision, in conjunction with domestic transfer pricing measures, provides a tax agency with capacity to adjust transfer prices to reflect the “true taxable profits arising in that State.” The OECD Commentary on Article 9 states that the Transfer Pricing Guidelines set out the conclusions of the OECD Committee on Fiscal Affairs on transfer pricing measures and these principles have been incorporated into the OECD Model. They have also been incorporated into the UN Model. The OECD states in the Commentary that the Transfer Pricing Guidelines are “internationally agreed principles and provides guidelines for the application of the arm’s length principle of which the Article is the authoritative statement.” (paragraph 1 of the Commentary on Article 9) The Commentary indicates that the Transfer Pricing Guidelines “is periodically updated to reflect the progress of the work of the Committee in this area.” (paragraph 1 of the Commentary on Article 9) The underlying principle of Article 9 of the OECD Model Treaty is that transfer prices for transactions between associated enterprises must reflect arm’s length prices.

155 The transfer pricing methods determine whether a transfer price for a controlled transaction is an arm’s length price. The traditional transaction methods compare controlled transfer prices to prices in uncontrolled transactions to determine if controlled transfer prices are at arm’s length. If appropriate comparable profits transactions are unavailable the non-traditional methods, which focus on net profits from controlled transactions, may be used. In practice, the traditional transaction methods may be difficult to apply at times because of the lack of comparative transactions.

156 Dr. Kobetsky underscored the importance transfer pricing by reference to the Ernst & Young transfer pricing surveys. The 2009 transfer pricing survey found that tax authorities are increasing their dedicated transfer pricing resources and improving their specialist capabilities. In addition, countries seem to be gearing up not simply for more audits but also for more transfer pricing penalties and for more disputes. In 2008, the survey found that more than 40% of all respondents identified transfer pricing as the most important tax issue.

157 Dr. Kobetsky introduced participants to the work of the UN Transfer Pricing Sub-Committee which is drafting a transfer pricing manual for developing countries. Dr. Kobetsky is a member of the Sub-Committee which has government representatives from developed and developing countries as well the private sector and universities. The Sub-Committee is in the process of drafting the initial chapters for the manual.

158 Dr. Kobetsky also considered the definition of permanent establishment and the business profits article. A developing country which enters a tax treaty gives up its source country taxation over business profits which are sourced within its borders. This is the part of the bargain of entering a tax treaty with a developed country. While tax treaties are reciprocal, trade and investment flows are uneven. Consequently, a developing country is giving up significant taxing rights over business profits when they enter into tax treaties. A source country has a taxing right under the business profits article of a treaty if the business has a permanent establishment within its borders. The rationale behind giving up source county taxing rights is to encourage international trade and investment. The term “permanent establishment” is defined in a treaty and the OECD Commentary and UN Commentary provide further guidance on the definition of a permanent establishment. Consequently, there is an incentive for developing countries to lower the permanent establishment threshold in order to acquire taxing rights over

profits attributable to the permanent establishment. Dr. Kobetsky emphasized that tax officials considering negotiating treaties with other countries should be aware that, in the absence of a permanent establishment, it is giving up its source country taxing rights over business profits.

XIII. A SURVEY OF TAX TREATIES IN THE SOUTH PACIFIC: RICK KREVER

159 The status of tax treaties entered into by South Pacific nations was the subject of a presentation by **Professor Rick Krever**, Director of the Taxation Law and Policy Research Institute at Monash University, Melbourne. The 13 Pacific Island nations covered in Professor Krever's survey have negotiated a total of 16 treaties with countries outside the region and inherited another three from colonial times. Only one treaty has been negotiated between members of this group, of the 78 bilateral treaties possible.

160 Professor Krever discussed the pros and cons for Pacific Island nations to enter into bilateral treaties. The main purpose of tax treaties is to allocate taxing rights between countries. They also contain measures to facilitate exchanges of information and to resolve disputes. One mechanism to achieve this latter goal is the mutual agreement procedure that can establish an agreed price for transactions between the jurisdictions.

161 In the absence of a treaty, a capital importing nation will have first taxing rights on all types of income sourced in that country. A treaty will remove completely the source country's right to tax some types of income and set an upper cap for the amount of tax that can be imposed on other types. This raises the question of why a developing country in need of tax revenue would enter into a tax treaty and give up taxing rights.

162 Importantly, tax treaties do not create any taxing rights. If the domestic law does not catch a particular type of gain, the fact that a treaty may allow a signatory to tax that type of gain will not impose any liability on a taxpayer deriving the gain. The liability must arise from domestic law.

163 Most studies to date suggest tax treaties do not by themselves attract FDI, though they are welcomed by those investors who may wish to access the dispute settlement process for transfer pricing disputes. Tax treaties may nevertheless be of value for a country. They may, for example, be part of a geo-political strategy and the trade off for conceding taxing rights through a treaty may be offset by other benefits of a closer relationship with the treaty partner. They may also be important as part of a broader "signaling" strategy, letting the world know that a country is part of the international economic community and plays by the common rules followed by other trading nations.

164 Several issues should be evaluated by a country considering entering into a tax treaty. A first is the priority should be an income tax treaty or an agreement to prevent cross-border difficulties with VAT laws. Economic unions have VAT agreements and if the South Pacific is to move toward broader economic cooperation, a VAT agreement may be of value.

165 In terms of an income tax treaty, an initial question is whether to enter into bilateral treaties with all of a country's neighbors or a regional multilateral treaty. A regional multi-lateral treaty may be far more efficient in terms of resources used to acquire a treaty with many countries at one time. A second question is whether to rely on the OECD Model, the UN Model or a country model as the basis for a treaty. As noted, the OECD Model favors capital exporting countries and the UN Model puts capital importers in a better position.

166 Two countries in the region, Fiji and Papua New Guinea, have a number of treaties with third countries. These treaties have elements from both the OECD and UN treaties and other sources. An illustration of this is the definition of a permanent establishment in their treaties. The OECD Model requires a non-resident working on a building or construction site to be present in the jurisdiction for at least 12 months before the presence will be considered to be a permanent establishment, the pre-condition for the source country to have any right to tax income generated by the work under a tax treaty. The UN Model, in contrast, only requires the non-resident to be at the site for six months for the presence to constitute a permanent establishment. Fiji's treaties contain thresholds ranging from 120 days (in the treaty with Papua New Guinea) through 6 months (in the treaty with Australia) to the full 12 months required by the OECD treaty (Japan).

167 Another illustration is the treatment of a "services" permanent establishment. The UN Model allows a source country to treat a service provider's presence in the jurisdiction as a permanent establishment if the service provider is present for six months in a 12 month period. The OECD Model does not directly recognize the provision of services as the basis for a deemed permanent establishment, although the Commentary to the Treaty does anticipate this possibility. All of Papua New Guinea's tax treaties apart from the treaty with Germany contain a services permanent establishment definition. The time required for a service provider's presence to give rise to a permanent establishment ranges from three months (in treaties with Canada and Australia) through 120 days in 365 days (in the treaty with Fiji) to six months (in the treaty with China) or 183 days within a 365 day period (in the treaty with the UK).

168 Some countries include in their treaties a definition that deems the use of "substantial equipment" in the jurisdiction to be a permanent establishment, enabling the source country to tax profits from the use of the equipment. Neither the UN nor the OECD Models have a provision along these lines. Papua New Guinea has included a measure deeming the use of substantial equipment to be a permanent establishment in a number of its treaties. While this measure is lacking in its treaties with Canada, Germany and the UK, the treaty with Australia deems the use of equipment for 90 days to be a permanent establishment, while the treaty with Fiji uses 120 days in a 365 day period and the treaty with China uses six months.

169 The OECD and UN Models both allow source countries to tax non-residents on gains from the disposal of land in the source countries. Formerly, only the UN Model supplemented this rule with a measure that extends the source country's taxing rights to gains on the sale of shares in a "land rich company", that is, a company whose value is mostly attributable to the land it owns. Fiji has this extended rule in its treaty with Australia but not in its treaties with Japan, New Zealand, Korea, or the UK.

170 The UN and OECD Models contain three "capping" measures that cap the maximum withholding tax that can be imposed by a source country on interest, dividends and royalties. The OECD Model stipulates maximum rates: 10% for interest (Article 10), 15% on dividends paid to portfolio (small holding) shareholders, 5% on dividends paid to direct investors (substantial shareholders) and zero tax on royalties (Article 12). The UN treaty leaves the rates open, simply stating they are to be negotiated between the parties.

171 Both Fiji and Papua New Guinea use the 10% OECD rate for interest in all their treaties apart from their treaties with Malaysia, which stipulates a maximum rate of 15%. Fiji's treaties with Australia, Korea, Malaysia, New Zealand, Singapore and the UK provide a single maximum withholding tax rate of 15% for dividends paid to both substantial and portfolio shareholders, while its treaty with Papua New Guinea contains a 17% maximum withholding rate for dividends

paid to all shareholders. It uses the dual rate formula in its treaty with Korea (a maximum 10% rate for direct investors and 15% for portfolio shareholders) and with Singapore (a maximum 5% rate for direct investors and 15% for portfolio shareholders). These two treaties use different thresholds to distinguish portfolio and substantial shareholders, with the Korean treaty adopting a 25% threshold for substantial shareholders and the Singapore treaty a 10% threshold. Papua New Guinea uses a single maximum withholding tax rate in its treaties, ranging from 25% in the treaty with Canada, through 20% in the Australian treaty, 17% in the Fiji treaty, and 15% in the rest of its treaties.

172 The Solomon Islands and Tuvalu both have treaties with the UK inherited from colonial times. These treaties deny the nations any taxing rights on dividends paid to UK shareholders.

XIV. WRAP-UP AND CLOSING TO SESSION: WORAPOT MANUPIPATPONG

173 The conference wrap up session was chaired by **Mr. Worapot Manupipatpong**, Director, CBT, ADBI, Tokyo. Mr. Manupipatpong noted the commitment of the ADB and ADBI to build the capacity of member nations to raise revenue needed for development and social well-being. The tax conferences are an important element of that program. He urged participants to make effective use of the networks they were able to build during the conference and to continue to share information and experiences in the future.

174 In closing, Mr. Manupipatpong expressed the sincere gratitude of the ADBI to the Government of Japan for its continued and generous financial support for the ADBI's tax forums and the predecessor conferences dating back to 1990. He also thanked the OECD, the International Bureau of Fiscal Documentation, the IMF, and the United Nations for their support for the Tax Conference Program.